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IN THE

Supreme Court of the United States

October Term, 1964

No. 489

UNITED STATES OF AMERICA,

Petitioner,

v.

ATLAS LIFE INSURANCE COMPANY,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

AMICI CURIAE BRIEF FOR STATE AND LOCAL GOVERNMENTS IN SUPPORT OF AFFIRMANCE

GRANT SAWYER, Governor of Nevada and Chairman of the *Governors' Conference*

LOUIS L. GOLDSTEIN, Comptroller of Maryland and Chairman of Committee on Taxation of State Bonds of the *National Association of State Auditors, Comptrollers and Treasurers*

JEROME CAVANAGH, Mayor of Detroit and Vice President of the *National League of Cities*

C. BEVERLY BRILEY, County Mayor of the Metropolitan District Government of Nashville—Davidson County, Tennessee and Immediate Past President of the *National Association of Counties*

ROBERT B. MATHIAS, County Counsel of Prince Georges County, Maryland and President of the *National Association of County Civil Attorneys*

C. D. WARD, General Counsel of the *National Association of Counties.*

MITCHELL WENDELL, Counsel to the *Council of State Governments*

JACK P. F. GREMILLION, Attorney General of Louisiana and President of the *National Association of Attorneys General*

JOHN J. O'CONNELL, Attorney General of Washington and Immediate Past President of the *National Association of Attorneys General*

JOHN J. GUNTHER, General Counsel of the *United States Conference of Mayors*

JOHN J. FLEMING, City Attorney of Milwaukee, Wisconsin and President of the *National Institute of Municipal Law Officers*

CHARLES S. REYNE, General Counsel of the *National Institute of Municipal Law Officers*

DANIEL B. GOLDBERG, General Solicitor of The Port of New York Authority, Counsel for the *Municipal Finance Officers Association* and Secretary of the *Conference on State Defense*

111 Eighth Avenue,
New York, N. Y. 10011.

Amici Curiae

With them on the brief:

CHARLES E. NORMAN,
City Attorney, Tulsa, Oklahoma.

MICHAEL S. ZARIN,
Attorney, The Port of New York Authority.

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Statement

This brief is submitted by representatives of States, counties, cities and other units of local government because the States and their subdivisions and the taxpayers represented by them have the largest stake in this review. We seek the affirmance of the unanimous decision of the Court of Appeals for the Tenth Circuit (in opinions per MURRAH, C. J. and BREITENSTEIN, J.), implementing the congressional "Exception" provisions so as to exclude interest on state and local government bonds from the computation of the tax on life insurance company income whenever the inclusion of such interest would produce a higher income tax.

The exemption protected by the Congress was not created for the benefit of life insurance companies or any other investors. They are mere conduits. State and local

governments are the beneficiaries. Without the adjustment authorized by the Exceptions, the conduit is clogged and the intended state and local government benefit is dissipated.

The apportionment or proration proposed by the Petitioner serves no purpose as between the company and its policyholders: the policyholders pay no tax. The actual proration would be as between the Federal Government and the States. What would be apportioned between them is the States' benefit from the exemption of state and local government bond interest.

For decades Congress has acted to assure the States and their political subdivisions that there would be no federal income taxation of the interest on their obligations. Accepting the urgent arguments of the States and their subdivisions that the exemption is critically important to their governmental independence and fiscal responsibility, Congress has consistently rejected Treasury Department attacks on the exemption whether mounted as frontal assaults for its outright repeal or as attempts to erode it in particular applications.

For decades the Treasury has represented to Congress that the exemption should be abolished or curtailed because it permits advantages to the investors in state and local government obligations and because it diminishes federal tax revenues. Every Treasury attempt has brought a confrontation with state and local government officers who detailed the importance of the exemption to state and local governments and the importance of state and local governments as vigorous partners in a federal system, and contended that any impairment of the exemption would be unconstitutional and harmful in practice. Not once has the Treasury position prevailed. By enacting the statutory exemption in the first and every subsequent income tax act and by refusing to repeal or amend it, Congress has adopted the state and local government viewpoint and, to use Petitioner's phrase, pretermitted the question of the constitutionality of the taxation which Congress declined to enact.

Thus, no investor in state or local government bonds has ever had to pay a federal income tax solely as a result of his receipt of interest on those bonds. This has been true with regard to every type of investor under every revenue act, whether he was an individual or a life insurance company or fell into any other category.

The question in this case is whether Congress in the Life Insurance Company Income Tax Act of 1959 has abandoned this consistent position and practice and instead sought the result that the receipt of state and local government bond interest shall produce an increase in income tax otherwise payable. The question is whether Congress intended that net result when it enacted both a formula and an "Exception" and where the formula in some, but not all cases, will produce that result and the "Exception" provides that "If it is established in any case that the [formula] * * * results in the imposition of tax on [state and local government bond interest] * * *, adjustment shall be made to the extent necessary to prevent such imposition." §§ 804(a)(6), 809(b)(4).

Petitioner argues that while Congress foreclosed any challenge to the continued *existence* of the doctrine of constitutional immunity of state and local government bond interest, Congress nevertheless deliberately provoked a judicial review of the constitutional *scope* of that immunity and specifically asked this Court to sanction a formula which, if adjustment is not made under the Exceptions, can result in a destruction of the major portion of the value of the exemption. It is the position of the States and their subdivisions that by the Exceptions, Congress sought to pretermit *any* constitutional question relating to the manipulation of state and local government bond interest in a statutory formula so that its receipt can produce a higher income tax. It is the position of your amici that Congress was as anxious to foreclose an attack which could dilute the beneficial effects of the immunity as to prevent an attack which would ask this Court to disestablish the immunity doctrine itself.

We agree with the Petitioner that "the function of the 'exception' clauses was to reassure those who were anxious to maintain the established immunity of State bonds and to prevent a defense of the statute which would cast that immunity in doubt." (Brief for Petitioner,[1] p. 15) We were among those seeking that reassurance and the reassurance we sought was not limited to the theoretical preservation of a truncated immunity but to the adjustment of the basic formula in every case in which it was established that higher taxes would result solely from the receipt of interest on the bonds issued by our States and subdivisions. We shared the *double* fear expressed by Senator Butler of the Senate Finance Committee (who as Petitioner admits (Pet. Br., pp. 66, 76) sparked the fight for the Exceptions), that the Treasury might make litigation under the Act the occasion (a) for seeking to have the whole doctrine of immunity overruled and (b) also for seeking to dilute its vigor and value by the device of "proration."

For that reason we resisted the House bill, which had no exceptions to prevent those results, and we supported the Senate bill which, over Treasury opposition, added the present Exception provisions to give us the reassurances we sought. When the House yielded and Congress enacted the Exceptions, we thought we had accomplished both our objectives, only to be told in this litigation that we had accomplished one but not the other.

Petitioner is faced in the present "Exceptions" with Congressional enactments which it concludes "are inoperative" (Pet. Br., p. 52) and "might well have been omitted." (p. 76). Faced with the absurdity of reading the Act as producing exactly the same tax result as if the "Exceptions" had not been enacted, Petitioner reads them so as to impute to Congress a deep concern to prevent judicial reexamination of the whole doctrine of immunity while at the same time imputing a willingness, even an eagerness, to provoke a constitutional litigation in which the Treasury would seek

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[1] Hereafter cited as "Pet. Br."

to limit the value of the immunity to the States. As Petitioner says (p. 59), there is a conclusive presumption "that Congress acted rationally and not from schizophrenia."

Petitioner appears to miss the whole point of the Congressional intercession. *Why* should Congress have been so concerned to thwart a suspected Treasury plan to attack "the whole doctrine of immunity," as Petitioner concedes it was? (Pet. Br., p. 76) Obviously not out of whim or caprice but because Congress holds important certain values which the immunity doctrine strengthens and protects. The "Exception" provisions must then go at least so far as is necessary to preserve those values as a matter of congressional policy; to be implemented by administrators and courts and not to be whittled away or destroyed by them.

The question is not whether any administrator or court at any point in time might hold the same policy values in this respect as Congress always has. We are dealing with "Exceptions" which were concededly enacted to prevent the raising of constitutional issues. We submit that the proration device supported by the Treasury can undermine those values. We submit that Congress believes that the immunity, undiluted, maintains the role of the States in our federal system, that the federal system should be preserved and that the role of the state and local governments should not be diminished. We submit that Congress believes that the cost of borrowing by the States and their agencies can and should be substantially held down by the immunity doctrine and the States and local governments thereby encouraged and enabled to cope with local problems out of their own resources. We submit that Congress believes that it is advantageous that local problems should be solved at the local level to the maximum extent possible. We submit that these values are offended by any "device or form of words"[1] which imposes the penalty of additional taxes upon the investor in state and local government bonds solely

[1] *National Life Ins. Co.* v. *United States*, 277 U. S. 508, 519 (1928).

as a result of his receipt of interest thereon. We submit that these values are equally offended by such a result no matter how produced and that they are not preserved by labelling the resulting tax as one not "on" but merely resulting from the receipt of the interest which is supposed to be wholly tax exempt. We submit that it is a crass charge to impute to Congress in the field of federal-state relations a concern for form but not for substance, for semantics but not results.

We submit that the Petitioner has broken faith with Congress and precipitated the very constitutional controversy which Congress sought to avoid.[1]

POINT I

The reasons for the congressional concern to preserve the exemption of state and local government bond interest.

It was not only out of concern for constitutional propriety that Congress enacted and reenacted the exemption of state and local government bond interest and struck down every attempt to repeal or curtail it. As stated by the Ninth Circuit Court of Appeals in 1940:

> "It appears from congressional reports and debates that not only was the exemption enacted and reenacted because of doubt as to the effect of the Sixteenth Amendment on a source of income previously

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[1] Once before, without waiting for Congressional sanction, the Treasury commenced what its press release called "a test action intended ultimately to prove in the courts that the Federal Government has the right under the Constitution to tax the income from State and municipal securities." (U. S. Treasury Dept. Press Service Release No. 24-3, March 14, 1941). While the rival views of the fiscal, economic and social impacts were aired in a full month of testimony and a mountain of exhibits in the Tax Court to prepare a record adequate for constitutional reevaluation, that Court declined to reach the constitutional argument, holding the bonds in question covered by the statutory exemption. *Shamberg* v. *Commissioner*, 3 T. C. 131 (1944). The Second Circuit affirmed, 144 F. 2d 998 (1944). This Court denied certiorari, 323 U. S. 792 (1945).

> declared immune by the Pollock case, but also on grounds of policy apart from the constitutional question." *Bryant* v. *Commissioner*, 111 F. 2d 9, 12.

Thus the Chief Counsel of the Bureau of Internal Revenue advised the House Ways and Means Committee in 1939 that

> "A study of the congressional debates and various committee reports in connection with the several revenue acts indicates that the failure of Congress to include interest from State and local securities in gross income is due in part to doubts as to constitutionality and in substantial measure to considerations of policy." Hearings, 76th Cong. 1st Sess., on Proposed Legislation Relating to Tax-Exempt Securities, p. 89

(1) The values to state and local government which Congress has chosen to protect.

The considerations of policy which Congress has appraised appear best by a review of the record in the three principal confrontations between the Treasury Department and Department of Justice on the one side, and the state and local government officers on the other.

In 1938-1940, 1942, and 1951, the Treasury Department and Department of Justice urged Congress to repeal the exemption and permit a new constitutional challenge. On each such occasion Congress retained the exemption intact after extensive hearings and testimony on both sides dealing principally with the fiscal, economic and social aspects of the proposal, and the impact on political balance between States and National Government in the federal system, as well as the constitutional aspects.[1]

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[1] Hearings before the Special Committee pursuant to S. Res. 303 (75th Cong.) between January 18 and February 16, 1939; Hearings before the Committee on Ways and Means on Proposed Legislation Relating to Tax Exempt Securities, between June 28 and July 11, 1939; Hearings before the Senate Committee on Finance, Revenue Act of 1942, July 23 and August 3, 1942; Hearings before the House Committee on Ways and Means on the Revenue Revision of 1942, March 27, 1942; Hearings before House Committee on Ways and Means on the Revenue Revision of 1951, February 26 and February 27, 1951.

The Treasury for its part stressed the potential increase in federal revenues and the argument that investors receive an undue tax advantage. State and local government representatives stressed the serious impact of increased interest costs and minimized the predicted federal revenues. They discounted on several bases the argument that the investor receives an undue advantage, pointing out that the investor pays for the advantage in large part by accepting a lower interest rate, that the argument of tax advantage was more theoretical than real because the actual distribution of holdings of state and local government bonds showed that most of them were held by banks, other corporations, institutions and governments and not by individuals, and that millionaire estates had a very small proportion of their assets invested in such bonds. They contended that to achieve more nearly perfect progression in the federal income tax structure by eliminating the exemption, it would be necessary to meet increased interest costs by increased local taxes, principally real estate and sales taxes, which are for the most part regressive.

State and local government officers have also insisted that the problem is not only one of added cost to state and local governments, although that has been a paramount consideration. They have also stressed that the tax might make borrowing utterly impossible under many circumstances. Some municipalities could not sell their obligations on a taxable basis (Cf. R. 45). This might be because the additional cost of borrowing would be beyond the financial power of the affected municipality to bear.[1] In other cases projects which were to be provided only on a self-supporting basis would cease to be self-supporting because of the added

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[1] When a floor amendment to repeal the exemption was proposed in 1938 it was defeated after arguments by Senators Tom Walsh and Alben Barkley that for

> "certain states whose financial difficulties are serious, and * * * certain counties and school districts * * * it would be practically impossible for them to raise money without the right to issue tax-exempt securities." 83 Cong. Rec. 5183.

cost of borrowing. In still other cases the municipality might be pushed beyond the statutory or constitutional limit on the rate it can pay. At a minimum, the tax would probably force a curtailment of governmental services at the state and local levels or increase the demand for federal aid or both.

But beyond that, assuming that a municipality would attempt to shoulder the burden of additional costs and keep its services unimpaired, the consequence would not be terminated when the borrowing first took place. Having assumed the added obligation, the municipality would have weakened its resistance to any subsequent jar to its economy. We are not so far from the times when the Municipal Bankruptcy Act was being applied that we can assume that municipal economies cannot collapse. As the Court said, "The notion that a city has unlimited taxing power is, of course, an illusion." *Faitoute Iron and Steel Co.* v. *Asbury Park,* 316 U. S. 502, 509 (1942).

It was to these continuing consequences of a tax on the interest from state and local obligations that the Court referred in *James* v. *Dravo Contracting Co.,* 302 U. S. 134, 153 (1937) when it said that the doctrine of immunity with respect to governmental bonds

> "recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' (Pollock *v.* Farmers' Loan & Trust Co., supra) and which would directly affect the government's obligation as a continuing security. Vital considerations are there involved respecting the permanent relations of the government to investors in its securities and its ability to maintain its credit * * *."

Finally, in all these Congressional debates the state and local officers stressed the governmental values of the federal system and the importance of protecting the proper place of state and local government and avoiding unnecessary centralization. They particularly feared that federal taxation would permit special exemptions for bonds issued for

favored federal policies of the moment and thus substantially displace freedom of choice of policies at the local level.[1] They invoked the opinion of Justices Douglas and Black that "The power to tax is indeed one of the most effective forms of regulation. And no more powerful instrument for centralization could be devised."[2]

These arguments show *why* Congress would not countenance an attack on the immunity doctrine and therefore why the operation of the Exceptions to foreclose that attack must be broad enough to protect not only some nominal doctrine of immunity but all the values so consistently preserved by Congress.

These considerations prompted your amici to seek amendment of the House bill involved in the present case. The objections of your amici could not be met by semantic distinctions between a tax on their bond interest and a tax "merely" resulting from receipt of their bond interest. They were trying to protect the market for their bonds from tax impact, no matter how labelled. They knew that a potential investor buys or passes up a "tax exempt" investment by gauging its after-tax value to him—i.e., by determining the relative after-tax result of receiving the coupon rate on the "exempt" bond and the higher rate on a taxable bond of comparable investment quality. The Record details that process in a typical Investment Committee (R. 45). It was the tax *result* admittedly flowing from the unadjusted formula which prompted the opposition to the House bill.

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[1] Thus in the days of generalized attacks on the exemption of state and local government bonds, housing authority bonds were singled out for continued exemption. (Hearings before the Senate Committee on Finance, Revenue Act of 1942, p. 543.) But in 1954, when general exemption was free from attack, housing bonds were singled out for particular taxation. The proposal was withdrawn. (Ways and Means Committee press release dated February 8, 1954.)

[2] Dissenting in *New York* v. *United States*, 326 U. S. 572, 593 (1946). Referred to in Hearings before House Committee on Ways and Means on the Revenue Revision of 1951, pp. 909, 916, 923-5.

True, state and local government officers deemed the result unconstitutional but they also deemed it objectionable as a partial repeal of the traditional exemption, for all the reasons which Congress had accepted over the years.[1]

Therefore once it is conceded that Congress meant "to reassure those who were anxious to maintain the established immunity of State bonds" (Pet. Br., p. 15), it follows that Congress intended the remedy to be sufficiently potent to avoid the threatened ailment complained of.

It is true, as Petitioner says (p. 74), that Congress "considered all the arguments pro and con over the desirability of the effects the bill admittedly would have" including "any adverse effects the bill might have on the market for State bonds." But note that Petitioner cites no record reference when it asserts that Congress, having considered all these arguments, "decided on balance * * * that any adverse effects the bill might have on the market for State bonds were not great enough to warrant giving to insurance companies the unfair advantage of duplicating deductions or exclusions."

We conclude exactly the opposite because each time since 1938 when Congress has balanced the adverse effects a tax proposal would have "on the market for State bonds" against the alleged "unfair advantage" of the investors, the verdict, as we have seen, has been to the contrary.

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[1] Indeed the Chairman of the Conference on State Defense, one of your amici, sought modification of the House bill to strengthen the state and local government bond market at a time when he still believed the formula met the minimum requirement of constitutional immunity. (Hearings before the Senate Finance Committee on H. R. 4245, 86th Cong., 1st Sess., [hereafter cited as "Hearings"] p. 121). It took careful study of the precise operation of the bill to uncover the fact that the formula produced a tax resulting from the receipt of state and local government bond interest. With such analysis completed, this state officer filed a second statement with the Senate Finance Committee while it was deliberating (but too late to be printed) correcting his prior erroneous constitutional opinion.

Therefore the Exceptions were devised to require adjustment "in any case" where the formula "results" in a higher tax than if the interest had been excluded from the calculations. Less does not fit the Congressional objective to protect state and local government.

(2) The effect of relative federal and state revenue needs on the congressional objective.

As against the recited gains for strong state and local government, what revenues did Congress give up by enacting the Exceptions? The estimate by the Treasury before enactment was "$35-$40 million" on the 1958 income.[1] The estimate by the life insurance company representative was "$32½ million."[2] Both these estimates, however, assumed an adjustment which is greater than the adjustment contended for by the Respondent and accorded by the Tenth Circuit. A computer calculation was recently made by analysis of 1132 actual income tax returns filed by life insurance companies who account for more than 90% of the total tax paid under the Act. It was determined that the difference in treatment of tax-exempt interest between the Tenth Circuit's view and the Petitioner's view is only $21.2 million a year on the average.[3]

The study also considered the possibility that an affirmance in this case might increase life insurance company investment in state and local government bonds. It reported the results of a calculation to determine the maximum revenue reduction possible if all companies switched to state and local government bonds to produce the maximum tax ad-

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[1] Hearings, p. 51.

[2] Hearings, p. 317.

[3] The National Underwriter, March 6, 1965, p. 1, by J. S. Hill. The figure for 1964 is $21.0 million. The low was $18.5 million for 1958 and the high $24.4 million for 1962. In 1963 it was only 3½% of the total tax paid by these companies under the Act.

vantage to themselves.[1] It recognized that switching will occur only if the tax advantage exceeds the reduction in interest rates accepted by the company in buying state and local government bonds of comparable quality to the taxable bonds sold. Therefore, a separate calculation was made not only on the assumption that yields on tax-exempt bonds would continue to have the same ratio they now have to yields on taxable bonds but also on the assumption that the ratio would be reduced if there were any major attempt to fit the foot of the $141.1 billion life insurance company assets[2] into the shoe of the $86.9 billion total state and local government bond debt already held by others.[3]

Based on the fact that at the present time municipal bond yields range between 71% and 68% of the yield on comparable corporate bonds, the calculation showed that if the ratio held at 68%, then companies paying 84% of the aggregate taxes paid by all the companies for 1963 could not profitably have reduced their taxes at all; and that companies paying the remaining 16% of the aggregate taxes, if they could have switched $3 billion of their assets, could have accomplished a maximum reduction of $44.9 million out of a total tax collected of $651.0 million. If the increased demand by life insurance companies reduced the ratio of municipal to corporate yields to 64%, then companies accounting for 90% of the aggregate taxes could not have profitably reduced their tax at all; and the companies

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[1] The article explained the process of calculation as follows: "A company * * * will not reduce taxes unless it can increase its income after taxes by so doing. Data from the 1963 tax returns were fed to the computer with a program which asked in effect, 'If an additional 1% of assets were switched to municipal bonds, would the after-tax income be increased?' This process was repeated as long as the answer was 'yes'. Running totals were kept of the total tax reduction and the amount of assets switched."

[2] 1964 Life Insurance Fact Book, p. 65.

[3] Annual Report of the Secretary of the Treasury for the Fiscal Year Ended June 30, 1963, p. 626. Actually for 1963, $3.9 billion (4.5% of the total outstanding in the hands of all investors) were already held by life insurance companies (2.7% of their total assets) 1964 Life Insurance Fact Book, p. 73.

accounting for the remaining 10%, by switching $2 billion of taxable securities into municipals, could at the outside have reduced their taxes by $32.0 million. As the yield ratio approached 60%, the ability for profitable switching was practically eliminated: companies accounting for 6% of the aggregate taxes were the only ones which could have done any profitable switching and the most they could have saved would be $9.8 million.

Of course, if this switch took place: (a) the present holders of the exempt securities would be switching tax-exempt into taxable investments and paying more taxes so that "total Federal revenues are unaffected"[1] and (b) relative to life insurance company taxes alone, if there is any additional federal loss it would be accompanied by additional state and local gain from the resulting interest reduction coming about from the strengthened market for state and local government bonds.

These figures should be appraised against the pattern of relative federal and state fiscal needs which was already emerging in 1959 and has recently become so apparent. The New York Times of February 1, 1965 (p. 13) contains an article by Joseph A. Loftus entitled "Fiscal Myth Exploded" and sub-titled "State and Local Budgets, Not Federal, Are Soaring—And Will Do So in Future." The article reports "State and local budgets are rising, and will continue to rise, because the fastest growing functions of government operate at those levels." It points out that "Forty per cent of state and local spending goes for education. More than 70 per cent goes for education, highways and health and welfare." These are the functions which increase most directly in proportion to the increase in population.

The article continues:

> "In five years or so, if there is no dangerous change in international relations, annual state and

[1] Hearings, p. 689. If the present holders switching their tax-exempts into taxables pay income taxes at higher rates than the life insurance companies, the net effect of the switch might even increase total federal revenues.

local spending will pass total Federal spending, including money for defense and foreign aid.

• • •

"No one disputes the fact that the states are struggling with real problems, that these problems are growing in size and complexity, and that Federal-state fiscal relations will affect the future nature of the Federal system."

Such a discussion is significant as background for congressional evaluation of arguments pointing out the adverse effects of "proration" on the market for state bonds. Thus another article[1] describes problems which arise "Since the Federal Government is likely to have embarrassingly large tax revenues in the future and since the states will unquestionably have embarrassingly small ones; and since the Federal Government is inhibited, for various reasons, from embarking on large-scale new expenditure programs, whereas the states have so much to do that they don't know what to do first • • •".

The article refers to "the already large, awesomely mounting total of state and local needs. In part the trouble here stems from our 'baby boom' of the late nineteen-forties. What was then only a perambulator parade has now swept through our elementary and high schools, and is in the process of inundating our colleges. As a result, state and local expenditures on education have exploded. Three billion dollars in 1945, $7 billion in 1950, $11 billion in 1955, $22 billion today and probably around $50 billion by 1975."

The article continues: "But education is not the only source of vastly expanded state and local expenditures. As urban and suburban areas have grown and population densities have increased, the cost of maintaining health and sanitation, recreation and transportation, welfare and simple public order has increased disproportionately. According to the National Planning Association, total spending by the states, towns and cities, already over $55 billion, will rise in another ten years to almost $155 billion."

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[1] New York Times Magazine of December 27, 1964 (pp. 8, 30, 31, 33), by Robert L. Heilbroner.

Since during the 1940's, when the Federal Government's needs were growing relative to the needs of the States, Congress did not deem "any adverse effects * * * on the market for State bonds" outweighed by the claim of "unfair advantage" to investors (Pet. Br., p. 74), it would seem to require proof—and the Petitioner has offered none—that Congress should in 1959 have brushed aside the admitted adverse effects of the Treasury proposal when the States face explosive needs relative to the Federal Government's.

It was more than reasonable under these circumstances that Congress should not only have been anxious to discourage "adverse effects * * * on the market for State bonds" but ready to give active encouragement to life insurance company investment in state and local government bonds to strengthen the market for them. Actually, as we have seen (supra, p. 13), there were during 1963 $141.1 billion of total assets of United States life insurance companies of which only 2.7% or $3.9 billion was invested in state and local government obligations.[1] For the same year there was an additional $82 billion of such obligations owned by others for an aggregate of $85.9 billion.[2]

With the growth in state and local debt bound to accelerate, even a small percentage increase in life insurance company holdings as a result of the 1959 Act would ease the financial pinch in which state and local governments were increasingly finding themselves. Per contra, Petitioner's interpretation would aggravate an already serious problem by creating new "adverse effects * * * on the market for State bonds." We submit that Congress accepted the view of your amici and not Petitioner's.

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[1] 1964 Life Insurance Fact Book, pp. 65, 73. The total assets figure increased each year from the level of $113.6 billion for 1959. The percentage of these 1959 assets invested in state and local bonds was 2.8%; it was 2.7% in 1963. This percentage was down from a high of 6.8% in 1940.

[2] Annual Report of the Secretary of the Treasury for the Fiscal Year Ended June 30, 1963, p. 626. Expressed as a percentage of all state and local government bonds outstanding, the life insurance company holdings were 5.2% of the total in 1959 and had declined to 4.5% in 1963.

POINT II

The scope of the traditional immunity of state and local government bond interest which was protected by the Congress in the Exception provisions.

We do not understand the order of the points in Petitioner's brief. Petitioner begins with a vigorous 33 page defense of the constitutionality of the basic formula and then proceeds to the perfect non-sequitur that "Since the statutory apportionment does not violate the assumed constitutional prohibition against a tax on state-bond interest, the 'Exception clauses' are inoperative." (p. 52).

As a matter of simple logic, since the Exception clauses are exactly what they are called, they must displace the basic formula wherever applicable and this is so whether or not the formula might be deemed constitutional. The question of the validity of the unadjusted formula is foreclosed by the Exceptions.

(1) The Exceptions should be interpreted to avoid, not to raise grave constitutional questions.

The first inquiry should therefore be into the scope of the Exceptions. Only if these can not possibly be interpreted to avoid the intense constitutional question is there any reason for the Court to confront it. If any straining is to be done in construing a statute it must be "in the candid service of avoiding a serious constitutional doubt" and should be indulged so long as the interpretation which has that result "is not barred by intellectual honesty." *United States* v. *Rumely*, 345 U. S. 41, 47 (1953). Or, as Mr. Justice Holmes said, "A statute must be construed, *if fairly possible*, so as to avoid not only the conclusion that it is unconstitutional, but also grave doubts upon that score." *United States* v. *Moy*, 241 U. S. 394, 401 (1916) (Emphasis added). See also *Crowell* v. *Benson*, 285 U. S. 22, 62 (1932); In re *Coates*, 9 N. Y. 2d 242, 253 (1961), app. dism., 368 U. S. 34 (1961).

Petitioner's interpretation not only fails to avoid grave doubts of the constitutional propriety of taxing the result of receiving State or local government bond interest; it unnecessarily raises that constitutional question and spends 33 pages defending its position. The Tenth Circuit's interpretation, on the other hand, has interpreted the Exceptions so as to avoid constitutional question and this was done not only without straining, but by giving the Congressional words their ordinary meaning.

According to Petitioner, nevertheless, the sole function of the Exceptions was to prevent a defense of the statute which would cast doubt on "the traditional constitutional immunity," "the established immunity of State bonds." (Pet. Br., pp. 14, 15). This was, of course an important function, but not the sole one. Since, however, Petitioner's case fails completely if the "traditional" and "established" immunity has not in the past encompassed proration as an allowable technique, we shall appraise the Exceptions in the light of the very test produced by the Petitioner.

(2) The origin and scope of the traditional immunity—no taxpayer has ever been required to pay a higher income tax solely as a result of the receipt of state or local government bond interest.

We are, therefore led to an inquiry as to what the scope of the "traditional" and "established" immunity has been. We are confirmed in this approach not only by the Petitioner's concession but by the fact that the Exception provisions identify the interest on which no tax is to be imposed as "any interest which under section 103 is excluded from gross income." (Sec. 804(a)(6)(A) and Sec. 809(b)(4)(A)).

Section 103 and all of its predecessors and all of its counterparts in life insurance company income tax acts have produced one invariable result in their codification of the "traditional" and "established" immunity:—under every single tax act, every taxpayer, including every life insurance company, has been authorized to exclude all of his or its state and local bond interest from the base upon which

his or its tax is computed; no investor in such bonds under any of these acts has ever been required to pay any taxes at all solely by reason of his receipt of interest on his loan to state or local government.[1] The "traditional" and "established" immunity has never meant that it was enough to tell the investor that state or municipal bond interest would increase his tax but by a smaller increment of tax than if the interest were paid by American Telephone & Telegraph Co.

When Congressman Cordell Hull introduced the bill to establish the first income tax in the Revenue Act of 1913, he explained that the exemption therein afforded to interest on bonds of States and their political subdivisions (which has ever since been retained and is now Code § 103) was included for the following reason:

> "* * * not desiring to raise any constitutional question, or to arouse the antagonism of any of the States, this provision was inserted." (50 Cong. Rec. 508).

"The antagonism of the States" which Congress thus sought to avoid could not then, any more than now, be averted, by a "device or form of words"[2] or by "ingenuity in calculation"[3] but only by *results* which preserve to them the *full* value of their immunity in reduced interest costs and resulting benefits.

The "constitutional question" which Congressman Hull did not want to raise again was, of course, the question settled in *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, 630 (1895) in which the Court said:

> "We have unanimously held in this case that, so far as this law operates on the receipts from municipal bonds, it can not be sustained, because it is a tax

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[1] The provision of the 1921 Life Insurance Company Act which would have been an exception to the statement in the text was the provision struck down in *National Life Ins. Co.* v. *United States*, 277 U. S. 508 (1928).

[2] Ibid. at p. 519.

[3] *Missouri* v. *Gehner*, 281 U. S. 313, 321 (1930).

> on the power of the states, and on their instrumentalities to borrow money and consequently repugnant to the Constitution."

It will be noted that in *Pollock* the Court indicated that what was objectionable was that "this law *operates on* the receipts from municipal bonds." This presaged the decision in *National Life Ins. Co.* v. *United States*, 277 U. S. 508 (1928), where the Court struck down a "device or form of words" which could also be said to "operate on the receipts from municipal bonds": it increased taxes and disallowed the benefit of the exemption to the investor, and therefore the governmental issuer, by reducing a deduction otherwise allowable to the investor. The Court said (at pp. 519, 520, 522):

> "One may not be subjected to greater burdens upon his taxable property solely because he owns some that is free. No device or form of words can deprive him of the exemption for which he has lawfully contracted.
>
> "* * * The burden from which federal and state obligations are free is the one laid upon other property. To determine what this burden is requires consideration of the mode of assessment, including, of course, deductions from gross values. What remains after subtracting all allowances is the thing really taxed.
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> * * * *
>
> "Congress had no power purposely and directly to tax state obligations by refusing to their owners deductions allowed to others."

At this point it was clear that the "traditional" and "established" constitutional rule with regard to state and local bond interest was that it should not be the occasion of greater tax burdens, whether they resulted from the direct inclusion of the interest in gross income or by the reduction of deductions otherwise available.

It is true that "proration" was not involved in the Act passed on in *National Life*. Proration consists of the partial

rather than the complete disallowance of the immunity by reducing otherwise allowable deductions to the extent of a part but not all of the immune interest. Any residual doubt that proration was an available technique to qualify the "traditional" and "established" immunity and disallow it pro tanto did not survive *Missouri* v. *Gehner*, 281 U. S. 313 (1930). It is true that *Gehner* involved the immunity of federal bonds from state taxation rather than the reverse and that it dealt with a property tax involving the proration of liabilities rather than deductible expenses. But these are distinctions without a difference. Proration was what the Court struck down and it did so on the precedent of *National Life* which did deal with state and local government bond interest and with an income tax. Proration was condemned because "Neither ingenuity in calculation nor form of words in state enactments can deprive the owner of the tax exemption established for the benefit of the United States. Nat'l Life Ins. Co. v. United States, 277 U. S. 508, 519, and cases cited * * *." 281 U. S. at 321.

It is significant that in *Gehner* the Court identified the exemption it was protecting from being burdened by the proration technique as "the tax exemption established for the benefit of the United States." By the same token the immunity asserted in *Pollock*, *National Life* and the present case is an immunity "established for the benefit" of the States. As Mr. Justice Cardozo said of the *Pollock* case in *Hale* v. *Iowa State Board*, 302 U. S. 95, 107 (1937):

> "By the teaching of the same case an income tax, if made to cover the interest on Government bonds, is a clog upon the borrowing power * * *."

The same reasoning emerges in *Helvering* v. *Gerhardt*, 304 U. S. 405, 417 (1938). There Mr. Justice Stone wrote that state immunity has been sustained where "the function involved was one thought to be essential to the maintenance of a state government: as where the attempt was * * * to tax income received by a private investor from state

bonds, and thus threaten impairment of the borrowing power of the state, Pollock v. Farmers' Loan & Trust Co."[1]

1942 brought a renewed attempt to secure repeal of the basic statutory exemption of state and local government bond interest and, as we have seen (supra p. 7), once again the Congress adopted the state and local viewpoint and retained the exemption intact.

1942 also brought a new Life Insurance Income Tax Act which, Petitioner claims, adopted the proration technique (Pet. Br., p. 17). But the fact is that under the 1942 Act, life insurance companies, like investors of every other class before and since, were allowed and required to pay the tax and only the tax which they would have paid if they had not entered into the transaction which resulted in their receiving state and local government bond interest. An example of this effect of the 1942 Act appears in the Record which shows

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[1] It was the *Gerhardt* case which precipitated the first major confrontation between the Treasury Department and the Department of Justice on the one side and state and local government officers on the other with regard to the proposal that Congress repeal the exemption of state and local government bond interest. After the decision in 1938, the Attorneys General of the various States organized the Conference on State Defense to fight the repeal of bond interest tax exemption. In response to their invitation all of the standing organizations of executive, legal and fiscal officers at the state, county and municipal levels and the organizations of state, county and local governments joined together in the Conference on State Defense which they have maintained these past 27 years. Your amici include those organizations.

The Department of Justice produced a study identified by the Petitioner (Pet. Br., p. 19, fn. 6). The Attorneys General of the States produced a counterstudy of 420 pages entitled "The Constitutional Immunity of State and Municipal Securities—A Legal Defense of the Continued Integrity of the Fiscal Powers of the States." A large scale report was prepared for the Comptroller of the State of New York entitled, "The Fiscal and Economic Aspects of the Taxation of Public Securities". All these studies were submitted to and evaluated by the Congress along with a mass of testimony on both sides which culminated on September 19, 1940 in the defeat of the proposal to end the exemption (86 Cong. Rec. p. 18621).

that the elimination of state and local government bond interest from the tax computations thereunder would not alter the actual tax payable (R. 45-6).[1]

In any event, by 1951 Congress had abandoned this approach and under each of the intervening acts as in the case of the 1942 and all prior acts (including 1921 after adjustment under *National Life*), it remained true that the receipt of state and local government bond interest in any tax year never involved for a particular life insurance company or any other taxpayer an additional tax liability for that year.

1951 also brought the Treasury's third frontal attack on the basic exemption since 1938, and it was defeated like the earlier ones (see p. 7, supra). Every Congress since

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[1] In the 1942 Act, state and local government bond interest was deducted from the company's gross income before the deduction for reserves and never appeared thereafter in the computation of the particular company's net taxable income. Congress permitted a deduction from the taxable income of an amount representing the expense requirement for additions to reserves. This deduction was to be a ratio computed annually in part on the basis of the total investment income of the entire life insurance company industry including tax exempt interest. Each life insurance company would pay the corporate tax rate on the remaining percentage of its own taxable investment income, whether or not the published ratio described its own additional reserve requirements and whether or not it had any tax exempt interest. Thus, while some tax exempt interest could enter into the computation of the industry-wide ratio, the actual tax of a particular life insurance company for any year was not increased by a penny because of the receipt of tax exempt interest that year. As MURRAH, C. J. observed below (R. 106-7):

> "But no taxpayer was induced to test the added tax burden as against the doctrine of *National Life*, apparently for two reasons: (1) the industry-wide reserve deduction percentage was so great that the individual company's net taxable investment income was miniscule; (2) each company could minimize its tax burden by purchasing tax-exempt securities because the income therefrom was not included in the computation of their individual tax liability."

has seen the introduction of bills to repeal or limit the exemption, but none has even reached the stage of hearings and none has been reported to the floor of either House.

The tradition is thus intact. No taxpayer of any class has ever had to pay a higher income tax solely as a result of receiving state or local government bond interest.

(3) Fairness forbids rather than requires the proration technique.

The arguments in Petitioner's Point I relate to a question with which we are not here concerned: the question of how to apportion a tax burden between the company and its policyholders. To such a controversy alone is there any relevance to Petitioner's contention that "Not only is that allocation perfectly reasonable but there is, we submit, no fairer method by which the allocation could be made." (p. 35).

But that is not the controversy here. Here we have a problem in federal-state relations and in the view of Congress as to what is fair as between the Federal Government and the States, not as between the company and its policyholders. On that subject Congress has already given its view contemporaneously with the present Act when in 1959 it amended the exemption of federal bonds from state taxation to provide:

> "This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax * * *." (73 Stat. 622).

The amendment was explained as being merely confirmatory of the prior simple statement of exemption. (Senate Report No. 909, 86th Cong., 1st Sess., p. 8).

This is the rule for which we contend. It requires adjustment whenever the interest if "considered directly or indirectly in the computation of the tax" would increase the

amount due. Proration of federal interest payments is thus outlawed for state income taxes. We may take this as the judgment of Congress in the same year in which the present Act was enacted, that proration has no place in the field of intergovernmental immunities—that as between the Federal Government and the States it is not only not a "fair" technique but a forbidden erosion of the traditional exemption.

The standard of "fairness" also suggests equality of treatment between different classes of taxpayers. If this standard is used in interpreting the Exceptions, then Petitioner has produced no evidence to dispel the conclusion that Congress wanted to treat all taxpayers alike to the end that state and local governments should have the full benefit of the traditional immunity from all potential investors.

The Exceptions themselves refer to Section 103 to identify the type of interest dealt with, although that Section has no direct operative effect on life insurance company income. Under Section 103 every other taxpayer excludes all interest from state and local government bonds in the computation of his or its tax and never pays a higher tax solely by reason of the receipt of such interest. Banks are not subject to a proration dilution of the exemption of their tax exempt bonds. The fact that some of their assets result from deposits on which they are indebted to the depositors does not change this result. The expense of paying interest on these deposits is deductible in full as an expense of doing business and is deducted from the taxable income only; state and local government bond interest does not enter into the computation.[1]

Petitioner's argument that Congress deemed proration to be the only fair method cannot stand alongside the fact that only by adjustment in accordance with the Exceptions could the basic formula of the Act be brought into line with what was deemed fair for all taxpayers including life insurance companies. Petitioner's argument that the required interest addition to reserves of life insurance companies is a "cost of producing income held constitutionally

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[1] Rev. Rul. 61-222, 1961-2 CB 58.

immune from federal tax" (p. 36) is also opposed to the standard which has always been used to determine the cost of producing tax-exempt income. In order for an interest expense to be a cost of producing tax-exempt income, it must be an interest expense which would not have been incurred if the tax exempt investment had not been made. The life insurance company's actual required interest addition to reserves is a fixed interest expense; it must be made each year whether or not tax-exempt bonds are held and its amount is wholly unaffected by the company's choice of investment portfolio. Petitioner seems to have confused an unavoidable interest expense of doing business with a contingent interest expense of producing tax-exempt income. Only the latter is traditionally non-deductible. See Int. Rev. Code § 265(2).[1]

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[1] The disallowance of interest on loans specifically incurred to purchase or carry tax exempt bonds has been in the law since 1918. It is the provision held constitutional in *Denman* v. *Slayton*, 282 U. S. 514 (1931). In 1933-34 the Treasury proposed a modification to require a proration reduction of a portion of the interest paid. The House passed such a provision in the Revenue bill of 1934 (H. R. 7835, 73rd Cong.). The Senate Finance Committee refused to concur and said in its report:

> "Your committee is of the opinion that the change made by the House bill will seriously interfere with the marketing of government securities, which are bought for the most part by banks and financial institutions • • •." (Senate Report No. 558, 73rd Cong. 2d Sess. p. 24).

The House receded (House Report 1385, 73rd Cong. 2d Sess. p. 17) and the law retained its traditional form.

Internal Revenue Service Technical Information Release (TIR-348) dated December 1, 1961 states:

> "The Internal Revenue Service announced today that the provisions of Section 265(2) of the Internal Revenue Code of 1954 have no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business since such indebtedness is not considered to be 'indebtedness incurred or continued to purchase or carry obligations • • •' within the meaning of Section 265 • • •."
>
> "The Service stated that although this has long been the position of the National Office of the Service, no specific publication of this point had been made."

The plea for equality of treatment between all classes of taxpayers, in the interest of fairness, was made in the legislative history, which we will review in Point III.[1] It was accompanied by warnings as to the dire effects which would flow from the extension to individuals, banks and others of the proration technique of eroding traditional immunity.[2] The Petitioner's new concept of expenses attributable to the cost of producing tax-exempt income makes those warnings particularly pertinent.

At this point it is enough to note that equality of treatment of all classes of taxpayers has been a part of the operation of the "traditional" and "established" immunity and that for all such taxpayers it has always been true that they have not been required to pay a higher income tax solely as the result of the receipt of state or local government bond interest.

The catchy label of "double allowance" (Pet. Br., p. 53) has never been used to prevent the exclusion of all their tax-exempt interest from the tax base of individuals, banks, insurance companies and others, although they may deduct all their costs of doing business from their taxable income alone. Or if Petitioner insists on calling this treatment a

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[1] Hearings, pp. 47-8 (Sen. Talmadge, quoted infra p. 43), 58 (Sen. Hartke), 700 (Sen. Butler, quoted infra p. 40), 106 (Mr. Shanks, quoted infra p. 40), 187 (Mr. Taylor), 305 (Mr. Cummings).

[2] See infra pp. 37-40. It is interesting to note that after the passage of the present Act, at least three local Internal Revenue Agents, zealous to apply the "logic" of the proration approach taken by the Petitioner in the present case, attempted in Massachusetts, Mississippi and New York to levy deficiency assessments on banks which had received state and municipal bond interest, by disallowing a portion of their interest payments to depositors. These attempts were, however, finally dropped, TIR-348, *supra*, p. 26. They too would have violated the traditional immunity and exemption of state and local government bond interest.

"double allowance", then the answer is that the "traditional" and "established" immunity and exemption encompass such an allowance.

(4) By citing cases in other fields Petitioner is venturing its prediction of the future of the immunity doctrine and not recognizing the doctrine's "traditional" and "established" scope as required by Congress.

"Tradition" and what is "established" must be found in the past, not in the future. When Petitioner seeks to derive from other cases, not dealing with the immunity doctrine, "a living, growing body of principles" (p. 59) allegedly inconsistent with *National Life* and *Gehner*, it is really suggesting that sometime in the future, perhaps in this case, the Court may be persuaded to depart from their teaching. Petitioner is thereby violating its own standard of applying the "traditional" and "established" immunity which it admits Congress sought to maintain. However phrased, Petitioner is merely venturing its prediction of the future, not reading the past.

The cases cited by Petitioner cannot change the tradition which Congress has chosen to respect. But at any rate they are not even inconsistent with the immunity cases themselves.

Of Petitioner's cases only *Denman* v. *Slayton*, 282 U. S. 514 (1931) has anything to do with state and local government bond interest. There the taxpayer by borrowing money to buy the bonds tried not merely to preserve but actually to reduce his otherwise tax liability. He tried not only to exclude in full his exempt interest like all other bond holders, but to deduct also the interest he paid to borrow the money and which he would not have had to pay if he had not bought the bonds.

National Life, Gehner and *Slayton* are perfectly consistent with each other. They all stand for the proposition that the transaction which produces tax exempt interest or holdings should have no tax effect: neither an increase in the tax as in *National Life* or *Gehner* and in the present case under Petitioner's theory; nor a decrease in the tax as was attempted in *Slayton*. Losing counsel in *Slayton* argued, as does Petitioner, that his client's position was the same as the position of the National Life Insurance Company. The Court, in an opinion written by the same Justice who wrote the opinion in *National Life*, dismissed this contention out of hand saying:

> "The circumstances disclosed in National Life Ins. Co. *v.* United States were radically different from those now presented, and the doctrine upon which that cause turned does not control the present one. The respondent here was not in effect required to pay more upon his taxable receipts than was demanded of others who enjoyed like incomes solely because he was the recipient of interest from tax free securities—a result which we found would have followed enforcement of the literal provisions of §245(a), Revenue Act of 1921, 42 Stat. 227, 261." 282 U. S. at 319.

Similarly, *Helvering* v. *Independent Life Insurance Co.*, 292 U. S. 371, 381 (1934) noted "the distinction between that exclusion from deductions [involved in *Slayton*] and the taxation of exempt securities condemned in Nat. Life Ins. Co. v. United States."

As for *Independent Life Insurance Co.* itself and the other "analogies" by which the Petitioner predicts the demise of *National Life* and *Gehner*, if only Petitioner can persuade this Court to review them, we invoke the language of Chief Justice Hughes, joined by Justices Stone, Brandeis, Cardozo and Black that

> "There is no ineluctable logic which makes the doctrine of immunity with respect to government bonds

> applicable to the earnings of an independent contractor rendering services to the government. That doctrine recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' (Pollock *v.* Farmers' Loan & Trust Co., supra) and which would directly affect the government's obligation as a continuing security. Vital considerations are there involved respecting the permanent relations of the government to investors in its securities and its ability to maintain its credit; considerations which are not found in connection with contracts made from time to time for the services of independent contractors." *James* v. *Dravo Contracting Co.*, 302 U. S. 134, 152-3 (1937).

When there is no "ineluctable logic" which applies the immunity of state and local government bond interest to other situations even though they have some relationship to government, it goes without saying that the remote "analogies" invoked by the Petitioner are no basis for predicting a future change in the scope of immunity. A fortiori they have nothing to do with the scope of the "traditional" and "established" immunity as it has been in the past.

After *Dravo* and *Gerhardt*, critics of the traditional immunity began predicting its immediate total demise (see Pet. Br., pp. 18-19), although both those cases acknowledged the continuing vitality of the bond interest tax immunity. It was fashionable with these critics to dismiss as a cliché, and at any rate as inapplicable to the States, Chief Justice Marshall's statement in *McCulloch* v. *Maryland*, 4 Wheat. 316, 431 (1819) that "the power to tax involves the power to destroy."

Yet eight years after *Gerhardt*, Justices Douglas and Black wrote in *New York* v. *United States*, 326 U. S. 572, 592-4 (1946):

> "But it is antagonistic to the very implications of our federal system to say that the power of Congress to lay and collect taxes, Article I, § 8, includes the power

to tax any state activity or function so long as the tax does not discriminate against the States.

* * * * *

"A tax is a powerful, regulatory instrument. Local government in this free land does not exist for itself. * * * Local government exists to provide for the welfare of its people * * *. Many state activities are in marginal enterprises where private capital refuses to venture. Add to the cost of these projects a federal tax and the social program may be destroyed before it can be launched. In any case, the repercussions of such a fundamental change on the credit of the States and on their programs to take care of the needy and to build for the future would be considerable. * * *the power to tax lightly is the power to tax severely. The power to tax is indeed one of the most effective forms of regulation. And no more powerful instrument for centralization of government could be devised.

* * *

"The immunity of the States from federal taxation is no less clear because it is implied."[1]

In any event our quest is not for the future of the tax immunity doctrine but for its "traditional" and "established" scope in the past.

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[1] Justices Frankfurter and Rutledge clearly did not agree with this dissent. The concurring opinion of Chief Justice Stone, joined by Justices Reed, Murphy and Burton accepted its philosophy but thought it inapplicable to New York State's "mineral water business." They said (at p. 586-7) "But we are not prepared to say that the national government may constitutionally lay a non-discriminatory tax on every class of property and activities of States and individuals alike. * * * a federal tax which is not discriminatory as to the subject matter may nevertheless so affect the State, merely because it is a State that is being taxed, as to interfere unduly with the State's performance of its sovereign functions of government."

Apart from problems in federal-state relations there is still another reason why the Court should decline to pursue the constitutional question raised in Petitioner's Point I. Even if the Exceptions could possibly be considered an invitation to the Court to tax state and local government bond interest to the extent that it does not offend the Constitution as it might be read today, we are led by *Helvering* v. *Griffiths*, 318 U. S. 371 (1943) to the result reached by the Tenth Circuit below. When Congress provided that a stock dividend shall not be treated as a dividend "to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution," the Court stated that it was nevertheless required to apply its own previous constitutional decisions, to ignore a claimed intervening trend against them, and not to reopen them to the end of enlarging the taxing power. Congress is deemed, without very specific evidence to the contrary, to be legislating within the limits of constitutionality as previously announced by this Court. Here, the comparable result is that Congress has enacted a requirement to make adjustments to meet the rule of *National Life* and *Gehner* as they stand. This is especially so since these cases were specifically stressed in the legislative history.[1]

Petitioner would distinguish *Griffiths* (Pet. Br., p. 61) as answering a question whether Congress "had in fact 'wanted' to tax" certain stock dividends. We have already shown in Point I what Congress "wanted" here. (See also Point III on legislative history). The fact remains that when Congress concededly invited a constitutional reexamination, the Court declined in *Griffiths*. A reexamination here should be denied a fortiori, since we start with Exceptions which are concededly intended to pretermit a constitutional question and the question is one in the delicate field of federal-state relations which the Court might well regard as requiring more stability than the field of stock dividends.

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[1] Hearings, pp. 43-4, 50-1, 305, 308, 516-18, 700-2.

Petitioner takes the position that by the Exceptions Congress "wanted" to foreclose constitutional litigation involving a reexamination of the existence of the immunity rule, but to provoke constitutional litigation involving a reexamination of the scope of the same rule. The only evidence offered is that Congress enacted a formula which must in some cases (but not all, as we shall show infra, pp. 49-51) be adjusted under "Exceptions" enacted at the same time. The Petitioner says (pp. 57-9) that to impute to Congress an intention that an enacted "Exception" shall undo an enacted rule in described cases, is to impute "self-contradiction," "schizophrenia" and action which is not "rational." To us it is a violation of the meaning of the word "Exception" to do otherwise and we submit that to impute to Congress a Janus-headed approach of both foreclosing and provoking grave and closely related constitutional questions in the delicate field of federal-state relations, is to impute "self-contradiction," "schizophrenia" and action which is not "rational."

(5) Petitioner's theory cannot explain the portions of the Exceptions which do not relate to the traditional immunity doctrine.

Most significantly, Petitioner's interpretation ascribes no meaning whatsoever to subdivisions "B" and "C" of the two Exception provisions.

Congress specified three classes of income which might occasion adjustment, and state and local government bond interest is only one of the three. The second class is the so-called partially tax-exempt Federal Government bond interest and the third is intercorporate dividends. These are classes of income which have nothing to do with the question of constitutional immunity of state bonds, which, according to Petitioner is the sole reason for the Exceptions. By the remotest stretch of the imagination, the failure to adjust with regard to them cannot raise this constitutional question and the taxation of corporate dividends cannot

raise any constitutional question at all.[1] How then can it be called "a fully satisfactory explanation of the 'exception' clause" that it "forestall[s] any challenge to the immunity of State bonds as a constitutional doctrine" (Pet. Br., p. 76)? With no such constitutional question to be "forestalled" for federal bond interest and intercorporate dividends, what role can be ascribed to these other integral parts of the same Exception provisions? Under what circumstances is adjustment to be made under them?

We suggest that the Tenth Circuit's rule does not suffer the vice of this failure to account for all the parts of the Exception provisions. The test of the Court below fits all three branches of the Exceptions. If the inclusion of the identified items of income produces a higher tax than if these items were excluded, then the adjustment is made with the exclusion so indicated.

(6) The Tenth Circuit's interpretation gives the language its normal meaning.

The test adopted by the Tenth Circuit fits the view that Congress was looking for certain pragmatic results and was not indulging in a semantic exercise as to the difference between a tax "on" items of income and a tax resulting from its receipt. Members of Congress are more likely to be concerned with the dollars and cents results of two rival tax proposals than with the niceties of philosophical causation.

In the Exception clauses, Congress called for adjustment if it is established in a particular case that the formula "results in the imposition of tax on" the identified items of income. The use of the word "results" was apt. It tends to refute Petitioner's semantic distinction between a tax "on" an item of income and a tax which "results" from its receipt.

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[1] There may be the very different question of impairment of the Government's contract obligations to its own bondholders if the Exceptions are deemed "inoperative."

We submit that Congress simply did not use the word "on" in the same way Petitioner does. It used the word in the way it is used in normal parlance.

Suppose an individual Congressman has in his checking account $75 more than he thinks he should keep idle, and he is about to buy a United States Savings Bond and wants to ask how the interest will affect his income tax. Is there any more natural way for him to phrase his question than to ask "Is there any income tax on the interest?" And would not the normal reply be: "You have to pay a federal income tax on the interest. But there is no state income tax on it." Does not the word "on" fit naturally?

What standard would have been used in asking or answering this routine question? It would be the normal standard of whether or not the item of income, if received, would add to the total income tax otherwise payable. And the "extent" of the tax "on" the interest would simply be the amount of tax the interest would add.

If this is a simple explanation, we count that as its prime virtue in seeking the intent of a Congress consisting of members of dozens of businesses and professions only a few of whom would claim to be tax philosophers. The virtue of this simple explanation cannot be destroyed by calling it "simplistic" and a "but-for" approach. (Pet. Br., pp. 22, 57, 59) Evidence, not epithet, is needed to reject the simple meaning of Congressional language when it reconciles all of the problems presented and squares so neatly with the Petitioner's own test of an intention to foreclose any challenge to the "traditional" and "established" immunity.

The evidence of legislative history, contained in our next point, only fortifies the conclusion reached by analyzing what Congress really "wanted," and what the scope of the "traditional" and "established" immunity has always been.

POINT III

The legislative history of the Act shows that Congress intended the basic formula for taxing life insurance companies to be displaced and adjusted in the case of any taxpayer whose tax under the basic formula would be increased solely as a result of its receipt of state or local government bond interest.

State and local government officers did not participate in the legislative history of the present Act until after H. R. 4245 was passed by the House. We were simply not aware at the time that the House bill produced the result which it did.

Let us review the approach and effect of the House bill. That bill did not rely on attribution of life insurance company income to policyholders to produce the tax result which the draftsmen desired in the case of the receipt by a life insurance company of interest on state and local government bonds. The approach was straightforward. The insurance company was required to go through the elaborate mathematical computations which produced its taxable income and each of the deductions to which it would be entitled. In arriving at the tentative tax base there was at first a total exclusion of all of the state and local government bond interest which the company might have received. Then, there occurred the "add-back" provisions (Sections 805(e) and 809(f)). The insurance company was thereby required to add back to the otherwise tax base a portion of the interest it had received on state and local government bonds and which had up to that point in the calculation been totally excluded from the tax base.

Before proceeding with the chronology it is important to note that the basic formula finally enacted, *apart from the Exceptions*, is identical with the House bill as to the tax resulting from the inclusion of state and local government bond interest in the computations. (This is conceded, Pet. Br., pp. 67-71). Therefore the Senate discussions of the objections

to the House bill all apply to the basic formula finally enacted, except as those objections were met by the Exceptions.

When the matter came to the Senate controversy arose on the House add-back provision. It produced a result under which a life insurance company could pay a higher tax solely as a result of its receipt of state and local government bond interest (R. 51). This could come about by the investment in state or municipal bonds of cash awaiting investment, or by the sale or maturity of low interest rate state or local government bonds and the reinvestment of the proceeds in the same type of bonds bearing a higher interest rate. To us, a greater quantity of "fully tax exempt" income should produce no more tax than a lesser amount of the same type of income; or than no income at all on the capital represented.

State and local public officials, on the basis of these comparisons, concluded that the House bill offended the requirement for a full and intact constitutional immunity and statutory exemption from federal income taxation of state and local government bond interest. They took their case to the Senate Finance Committee, the record of whose hearings includes some of the considerable opposition which the House bill engendered.

The American Municipal Association (now the National League of Cities), one of your amici, which represents 13,000 municipal governments, submitted a statement in which the House bill was characterized as "* * * the opening wedge to apply the same principle to all other taxpayers." That statement also noted the "* * * higher interest rates which State and local governments would have to pay if such a Federal tax were imposed on all their bonds in the future."[1]

Another of your amici, the National Association of Counties, which represents 6000 counties, endorsed this statement.[2] Other protests are recorded directly[3] or are

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[1] Hearings, p. 699.

[2] Hearings, pp. 699, 700.

[3] Hearings, p. 593.

reflected in Senator Butler's reference to "the many statements the Finance Committee has received from municipal groups warning of the grave danger this proposal holds in store for them."[1]

The Chairman of the Conference on State Defense, another of your amici, opposed the add-back in the House bill solely on policy grounds.[2] On April 8, 1959 after the Senate Finance Committee Hearings had closed, but as the deliberations of that Committee were proceeding, he filed a formal supplemental statement asserting the unconstitutionality of the add-back in the House bill and adding:

> "A further and compelling reason for amending Sections 805(e) and 809(f) to avoid the add back 'adjustment' for state and municipal bond interest is that the theory of 'double deduction' has not been applied by Congress in other situations where taxpayers might be subjected to the penalties of a similar approach. * * * The bank which pays interest on savings accounts is not required to add back any portion of its income from municipal bonds on the theory that interest paid to depositors should be similarly allocated."

Another example of the traditional meaning of the immunity and exemption of state and local government bond interest was pointed out in that statement to the Senate Finance Committee as follows:

> "The individual who has made charitable contributions is not required to add back any portion of his income from municipal bonds on the theory that the contribution should be allocated between taxable and tax-exempt income."

The statement went on to say:

> "* * * Such an approach in the case of individual banks or other taxpayers similarly situated would

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[1] Hearings, p. 701.

[2] Hearings, pp. 121-2. See footnote 1, p. 11, supra.

> obviously whittle away at the inherent benefit which the constitutional immunity is intended to afford state and local governments."

State and local governments were not alone in terming the House bill a tax on state and local government bonds. In the Senate Hearings, Senator Talmadge was questioning Mr. Carrol M. Shanks, President of Prudential Insurance Company of America.[1] Senator Talmadge said:

> "Mr. Shanks, I would like to ask you about one matter you didn't testify about. It is one that has been brought up by others, and that is the provision for taxation of tax-exempt bonds.
>
> "Is it your opinion under the terms of the act which we are asking to report to the Senate, tax-exempt obligations would be taxable?"

Mr. Shanks replied:

> "It is my opinion that we would get only a proportionate amount of the tax exemption. Therefore, to that extent I suppose you might say they are taxable."

Senator Talmadge pursued the question of the impact of the provision and the following colloquy took place:

> "Mr. Shanks. There is no question but what, if you take away part of the tax exemption, it makes them less desirable because probably their main appeal is their tax exemption.
>
> "Senator Talmadge. You think, then, that that might result in increased interest rates for tax-exempt obligations in municipalities, counties, and States?
>
> "Mr. Shanks. Well, I don't know how much of an impact the insurance buying would have, but to the extent that it had an impact, it would make the bonds harder to sell, and you would have to pay a higher interest rate."

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[1] Hearings, pp. 105-6.

Then Senator Talmadge suggested the possibility of amendment "to clarify the exempt status". Mr. Shanks replied:

> "Well, I haven't prepared myself to testify on it. I don't think it would affect our company very much, but I understand that a number of people are going to testify on it, but certainly if they are tax exempt with other industries and other companies, they ought to be tax exempt with the insurance companies."

Other examples, considered by the Senate Finance Committee, of ways in which the House bill would have taxed income immune from taxation were developed in connection with the testimony of other life insurance company representatives.[1]

Of particular importance is the statement placed in the record by Senator Butler,[2] since it is identified by the Petitioner (Pet. Br., p. 76) as "a reason for adding" the Exceptions. Senator Butler opposed the House bill for four independent reasons: because it "taxes tax-exempt interest, is unconstitutional, discriminatory and would have a serious and adverse effect on the State and municipal bond market."[3]

Petitioner's explanation of the Exceptions as designed solely to foreclose a particular constitutional challenge meets only part of one of Senator Butler's four points. It does not meet his objection to taxing tax-exempt interest, to discrimination and to adverse market effect. It does not even meet in full his objection of unconstitutionality.

It is certainly true that Senator Butler believed that the Treasury was seeking to "strike down the whole tax exempt doctrine."[4] That fear, both sides now agree, was dispelled

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[1] Hearings, pp. 187-8, 252, 305, 405, 687.

[2] Hearings, pp. 700-2.

[3] Hearings, p. 701.

[4] Hearings, p. 702.

by the Exceptions. But Senator Butler was also unequivocal in seeking to overturn "the Treasury stand" because, among other reasons, "In *National Life Insurance Co.* v. *United States* (277 U. S. 508 (1928)) and in *Missouri* v. *Gehner* (281 U. S. 313 (1930)) the Court in the plainest and most emphatic language has characterized formulas as contained in H. R. 4245 as unconstitutional. Despite more recent decisions on collateral questions these decisions remain unmodified and unchallenged. As such they are the only appropriate guide posts in considering this vital question of constitutionality."

Under questioning by Senator Butler, the Assistant to the Secretary of the Treasury defended the House bill but not on the ground that the House formula avoids the imposition of a tax on state and local government bond interest. First, Senator Butler asked:[1]

> "When you speak of a deduction to avoid a double benefit, you are in reality saying that you are charging a part of the operating expense against tax-free interest?"

And the Assistant, Mr. Lindsay, replied:

> "Yes, I think that is probably a fair statement."

And then Senator Butler asked:

> "Why do you tax that interest even partially?"

And Mr. Lindsay's answer was:

> "Because we think it is right."

The Treasury thereby conceded the partial taxation which state and local government officers were protesting, and of which they sought correction in the Senate Finance Committee.

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[1] Hearings, p. 43.

It was with this background that the Senate Finance Committee proceeded with its deliberations. Within the subject matter of this law suit, two major changes emerged and were reported to the Senate. The first was a change in language as to the basic formula, and the second was the addition of the critical Exception provisions.

In re-casting the basic formula, the Senate Finance Committee attributed a portion of the life insurance company's income and exemption to the policy holders who are the principal creditors of the company. This approach eliminated the *words* appearing in the offensive add-back provision in the House bill, but the significant fact is that it did not change by so much as a penny the *tax result* of the House bill, including the add-back provision (R. 49, 51). This is conceded by Petitioner (Pet. Br., pp. 67-71).

The new wording did not therefore answer the complaints of the Senators quoted and of state and local government officers that the market for their bonds would be adversely affected, that a portion of their benefit from the traditional exemption and immunity was being destroyed and that aside from the practical consequences of that destruction, it raised the danger of a new constitutional controversy in the field of inter-governmental relations. It did not answer the objections that the bill was unfairly discriminatory as between taxpayers. It did not answer the objections of Senator Talmadge who had bluntly told the principal Treasury witness that the Act should "make it uniform" for all classes of taxpayers, and that the economic effect of the House bill on the States and local governments rendered the bill not only undesirable, but unconstitutional. Senator Talmadge stated:

> "It would be a very important thing not only to insurance companies but to counties, States, and municipalities that build hospitals, school buildings, and things of that type, if they suddenly found their interest rate raised to the degree of maybe three-quarters of 1 percent. This being true when trying to be competitive in the market when selling their obligations. This is important not only to the insur-

ance companies and the taxpayer, but it is of vast importance also to those subdivisions of State governments in States at the present time which have tax-exempt status.

> "I think we ought to make it uniform if we are going to attempt it, and I don't think we can constitutionally, under the present law, tax obligations of States, counties and municipalities. I certainly think we ought to make it uniform and operate it in the same way with reference to an individual taxpayer, a bank, a casualty company, and others, as we would to an insurance company." (Hearings, pp. 47-48).

Obviously, it was the second change which the Senate Finance Committee introduced which alone dealt with these problems: the addition of the two Exception provisions.

Chairman Byrd of the Senate Finance Committee reported this amended bill to the Senate with a detailed statement, advising that it avoided any tax on state and local government bond interest (105 Cong. Rec. 8401).[1] The Treasury contribution before the Senate was opposition to the Exception provisions proposed by the Finance committee. In a letter addressed to Senator Byrd, Committee Chairman, on May 18, 1959, from the Assistant to the Secretary, which appeared in the Congressional Record of May 19, 1959, it was stated for the Treasury:

> "In our opinion, this additional language is not necessary, since we cannot envision a situation in which the operation of the proposed tax formula would result in the substantive imposition of tax on municipal bond interest or on any other form of tax-exempt income." (105 Cong. Rec. 8402)

This objection was swept aside.

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[1] We find no evidence to support Petitioner's statement (p. 65) that it was Senator Curtis, a junior Committee member of the minority party, "who was chosen [by the Committee?] to explain the Committee bill to the Senate." A similar statement was made below by the Petitioner (then Respondent), was not questioned by the taxpayer or by us and appeared in the opinion below.

And so, the Senate adopted amendments which not only re-cast the House basic formula, but required adjustment of the results thereof under the Exception provisions.

The matter then went to conference between the House and the Senate. While the Record, of course, does not show it, state and local government officers, including many of your amici, then addressed their petitions and arguments to the House conferees to support the Senate version.

Our arguments were not arguments indicating a semantic preference for one phrasing over another. Our arguments related to the actualities of the tax penalties and burdens on state and local governments which the basic formula produced (in both the House version or under the Senate formula before adjustment under the Exception provisions) solely because of the receipt of state and local government bond interest. In opposition to the Treasury's assertion that the Exceptions were "not necessary," we urged the House conferees to yield and accept the Exception provisions in order to achieve a *practical* result in having that full measure of the traditional exemption and immunity and that full measure of benefit to state and local governments resulting therefrom which we have outlined in Points I and II.

The House conferees recommended to the House that it yield to the Senate and accept the Exception provisions. (Report No. 520, 86th Cong., p. 15.) The House agreed, and when the matter was reported to the Senate for action on the final conference report, the matter was again presented by Chairman Byrd of the Senate Finance Committee. He said (105 Cong. Rec. 10400):

> "I am glad to report to the Senate that the House conferees accepted the Senate amendment relating to tax-exempt interest. This amendment provided that if it is established in any case that the application of the definition of taxable investment income results in the imposition of the tax on any tax-exempt interest * * * adjustment shall be made to prevent such imposition."

Senator Thurmond then asked:

> "* * *. As I understand from the report, county and municipal bonds will not be taxed under the bill. Is that correct? Is that the Senator's construction?"

The Senate Finance Committee Chairman answered:

> "That is my construction. There is a proviso that if by any chance under the bill they will be taxed, necessary steps will be taken to refund the tax.
>
> "Mr. Thurmond. I thank the Senator.
>
> "Mr. Byrd. That provision was not changed in conference.
>
> "Mr. Thurmond. I thank the distinguished Senator for furnishing that information. I was vitally interested in it. I believe it means a great deal to the people of our Nation to preserve our State and municipal bonds untaxed by the Federal Government.
>
> "Mr. Byrd. I agree with the Senator from South Carolina."

It will be noted that the Senate Finance Committee Chairman spoke of "necessary steps * * * to refund the tax." That is the nature of the present action.

It will also be noted that the two Senators agreed that "it means a great deal to the people of our Nation to preserve our State and municipal bonds untaxed by the Federal Government." Obviously, it means nothing beneficial in this context to "preserve our State and municipal bonds untaxed" by producing the tax result contended for by the Treasury in this case and merely labelling it something other than a tax on state and local government bond interest.

It would be a crass charge to suggest that in the foregoing colloquy Senator Byrd disingenuously had his tongue in his cheek and meant that the bill he had worked for, with the new Exception provisions, still authorized the taxation of the holders of state and municipal bonds solely because of their receipt of interest on those bonds, and that the conferees harbored a secret and unexpressed rationalization

that this did not constitute a tax "on" that interest. The questions asked by Senator Thurmond and answered by Senator Byrd were the result of state and local government protests and Senators' opposition as to the *pragmatic* effect of the House bill. They could *not* be answered solely by re-casting the House bill into a different "device or form of words" with the identical practical result. Other Senators who heard this debate, without the Committee's detailed knowledge of the intricacies of the taxing formula, could not for a moment have believed that they were voting for a measure which increased a tax solely because of the receipt of interest on municipal bonds.[1]

Petitioner nevertheless contends that this "is self-contradiction," pointing out that in the Tenth Circuit view some of the result of the basic formula is undone by the Exception provisions, and concludes that "no rational body would consciously set out to accomplish that result by

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[1] Compare *Sinclair Refining Company* v. *Atkinson*, 370 U. S. 195, 209 (1962), in which the Court said:

> "The unequivocal statements in the House Conference Report and by Senator Taft on the floor of the Senate could only have been accepted by the Congressmen and Senators who read or heard them as assurances that they could vote in favor of § 301 without altering, reducing or impairing in any manner the anti-injunction provisions of the Norris-LaGuardia Act. This is particularly true of the statement of Senator Taft, a man generally regarded in the Senate as a very able lawyer and one upon whom the Senate could rely for accurate, forthright explanations of legislation with which he was connected. Senator Taft was of course entirely familiar with the prohibitions of the Norris-LaGuardia Act and the impact those prohibitions would have upon the enforcement under § 301 of all related contractual provisions, including contractual provisions dealing with arbitration. If, as this argument suggests, the intention of Congress in enacting § 301 was to clear the way for judicial obliteration of that Act under the soft euphemism of 'accommodation', Senator Taft's flat statement that the Conference had rejected the repeal of the Norris-LaGuardia Act *could only be regarded as disingenuous. We cannot impute any such intention to him.*" (Italics added.)

repealing in one provision what it enacted in another." (Pet. Br., p. 57).

We do not understand this objection. Draftsmen frequently use provisos to limit a generalization which has gone too far. An Exception provision, as its name indicates, can have no other purpose—according to Webster an exception is a "restriction which would otherwise be included."

But here there is still another consideration which is consistent with complete rationality on Congress' part. Congress consists not of one but of two Houses. When the Senate Finance Committee came to the conclusion that it would meet the objections voiced by its members and by a host of state and local governments, it was faced with the fact that its views could not prevail unless the House yielded. How the amendment would be cast might well strengthen or weaken the chances of procuring House acquiescence. Was it not more likely that the change could be "sold" to the House in a form which retained the House formula in effect if not in words and then attached exceptions?

The process of compromise between two Houses, as between the members of a single legislative body or even a pair of attorneys working up a contract between their respective clients, may well produce a final document which would be different in form if the process of accommodation were not necessary. This does not prove either irrationality or self-contradiction. In a metaphoric sense a bicameral legislature will often have a "split personality" without inviting the Petitioner's diagnosis of "schizophrenia." (Pet. Br., p. 59).

The legislative history shows that Petitioner's interpretation of the Exceptions is untenable. The Congress should not thus be charged with being "disingenuous." (Cf. *Sinclair Refining*, supra.). It preserved the full and traditional exemption and immunity of state and local government bond interest for life insurance companies on a parity with all other investors in state and local government bonds, without any erosion by proration.

POINT IV

The necessity of giving meaning to the Exception provisions.

The Treasury Department argued to the Senate that the Exception provisions were "not necessary" (105 Cong. Rec. 8402). This was an understandable argument in a lobbying effort to beat the proposed Exception provisions. But it became an impossible interpretation once Congress rejected the Treasury Department view and enacted the provisions.[1]

And yet the Petitioner still argues that "the 'exception' clause might well have been omitted." (Pet. Br., p. 76), thus concluding a point whose caption states "the 'exception clauses' are inoperative." (Pet. Br., p. 52).

In Petitioner's view an adjustment will never be made under the Exception provisions: they are "inoperative." To Petitioner the Act produces exactly the same tax consequences to Respondent or any other taxpayer as if the Exception provisions had never been enacted: they "might well have been omitted."

Yet no part of a statute can be interpreted as nugatory if the Court can possibly give it effect. As stated in *United States* v. *Menasche*, 348 U. S. 528, 538-39 (1955):

> "* * * 'The cardinal principle of statutory construction is to save and not to destroy.' National Labor Relations Board *v.* Jones & Laughlin Steel Corp., 301 U. S. 1, 30. It is our duty 'to give effect,

[1] When Chairman Byrd reported the Finance Committee Bill to the Senate, he said "The Treasury has assured the committee that this formula does not impose any tax on tax-exempt interest." But apparently these Treasury assurances were not enough because the Chairman went on in his next sentence to say "The bill adds a proviso to the effect that if the formula I have described does result in the imposition of tax on this item, the formula is to be adjusted so that it does not do so." (105 Cong. Rec. 8401).

> if possible, to every clause and word of a statute,' Inhabitants of Montclair Tp. *v.* Ramsdell, 107 U. S. 147, 152, rather than to emasculate an entire section, as the Government's interpretation requires."

Petitioner suggests that the Tenth Circuit interpretation is faulty because, Petitioner says, "the exception clause comes into play to the same extent, if at all, in every case in which the company receives State-bond interest" (Pet. Br., p. 56, fn. 24) and adjustment will "always" be made (p. 57).

If this were so, it would still not be an objection to the Tenth Circuit position. Where there is a rule and an "exception" the "exception" must prevail even if it completely displaces the rule. But the Petitioner is wrong in concluding that in the Tenth Circuit view the Exceptions will "always" require an adjustment if the company receives state or local government bond interest. The adjustment would be made if and only if exclusion of the interest from the computation would produce a lower tax result than inclusion of the interest. And this is not always the case, as even Petitioner implies.[1]

For example, Respondent's brief shows that it would not be so in the case of a company with an investment yield of under $250,000 and with a low ratio of reserves to assets, for which the small business deduction may be larger

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[1] Footnote 7 on page 20 of Petitioner's Brief qualifies the text statement on that page that in computing "gain from operations" "the receipt of an increment of tax-exempt income, all other things being equal, will necessarily increase the amount of taxable income the company has after additions to the reserve, and will thus increase its total tax." The footnote says that this "result will *normally* occur also under the definition of 'taxable investment income' but whether it will *necessarily* occur depends upon what assumptions are made * * *." (Italics the Petitioner's). The qualification has substantial application since the Senate Finance Committee Report estimated that 92% of the total estimated tax receipts would be derived under Phase I, which is "taxable investment income." (Sen. Rep. 291, 86th Cong. 1st Sess., p. 12)

than the increase in the taxable items of investment income taxed to the company which results when the larger "investment yield" is used to determine the "policyholders' share" exclusion.[1]

Another example would occur if the five year "average earnings rate" is lower than the "current earnings rate" as a result of a drop in the extent of state and local government bond interest received. Many factors could cause such a drop. The granting of certiorari in this proceeding might have induced some companies to reduce their investment in state and local bonds. A drop in interest rates of municipals relative to corporates (such as happened in the 1940's) could produce the same result by inducing insurance companies to switch to taxable bonds. A drop in corporate tax rates which would make the exemption less valuable is a third possibility. A fourth would be the growth of a company in size and investments during the five year period without increasing proportionately its investments in state and local government bonds.[2]

That the tax would sometimes increase if state and local government bond interest were always excluded from the computation was confirmed by the same David Lindsay who had testified for the Treasury in the Senate Finance Committee on the House bill. After he had become General Counsel of the Treasury Department, in a letter dated November 27, 1959 to the Secretary of the Conference on State Defense, one of the signatories of this brief, Mr. Lindsay said that under such circumstances

> "A company which has proportionately higher investments in municipals (or in stocks) in any one

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[1] In fact there were such companies in the period 1960-3. The National Underwriter, March 6, 1965, p. 22.

[2] Actually the industry as a whole has revealed such a trend. The percentage of total assets invested in state and local government bonds was 6.8% in 1940 but only 2.7% in 1963. 1964 Life Insurance Company Fact Book, pp. 65, 73.

> or more of the four years preceding the taxable year than in the taxable year would pay a higher tax than an identical company which did not have corresponding investments in municipals in any of the four years preceding the taxable year."

These are examples of cases in which adjustment would *not* be made because the basic formula cannot be said to result in the imposition of tax on state and local bond interest if its inclusion produces a lower tax result than its exclusion.

This is important when we look at the exact language of the Exceptions. They do not provide for an adjustment in every situation and they certainly do not provide, as Petitioner contends, that the adjustment shall never be made. What they say is that the adjustment shall be made "If it is established in any case" that the formula results in the imposition of the prohibited tax. The Respondent has made the showing which entitles it to the adjustment for the year in question. Other companies in particular years may not be able to make that showing. But the test adopted by the Tenth Circuit is one which fits the language of the statute, while Petitioner's view flagrantly fails to do so.

Nevertheless, Petitioner claims to illustrate "The bizarre implications of imputing to Congress a purpose to adopt its own independent standard of what a tax is 'on' " (Pet. Br., pp. 56-7), as if self-contained legislation is unthinkable. This is the obverse of Petitioner's claim that the only acceptable standard to determine whether adjustment shall be made under the Exceptions is "some external standard" (p. 55). The Petitioner then claims Congress intended "some superior external standard with which the courts were more familiar than the Congress" (p. 56). In other words, Petitioner concludes that Congress delegated to the courts the completion of the legislative process.

Such a view comes suspiciously close to offending the doctrine of separation of powers. In any event it con-

tradicts the Court's view of its function as illustrated in *Sinclair Refining Co.* v. *Atkinson*, 370 U. S. 195 (1962). There, the Court said (p. 209):

> "We cannot accept the startling argument made here that even though Congress did not itself want to repeal the Norris-LaGuardia Act, it was willing to confer a power upon the courts to 'accommodate' that Act out of existence whenever they might find it expedient to do so in furtherance of some policy they had fashioned under § 301."

The Court refused to impute to Congress an intention "to clear the way for judicial obliteration of that Act under the soft euphemism of 'accommodation' * * *." In rejecting an argument very closely parallel to Petitioner's here, the Court said (370 U. S. at 209-10):

> "Moreover, we think that the idea that § 301 sanctions piecemeal judicial repeal of the Norris-LaGuardia Act requires acceptance of a wholly unrealistic view of the manner in which Congress handles its business. The question of whether existing statutes should be continued in force or repealed is, under our system of government, one which is wholly within the domain of Congress. When the repeal of a highly significant law is urged upon that body and that repeal is rejected after careful consideration and discussion, the normal expectation is that courts will be faithful to their trust and abide by that decision. This is especially so where the fact that the controversy over repeal and the resolution of that controversy in Congress plainly appears in the formal legislative history of its proceedings."

If for "the soft euphemism of 'accommodation'" we substitute "the soft euphemism of 'proration'," and if for the proposed "judicial repeal of the Norris-LaGuardia Act" we read the proposed "judicial repeal of the essence, if not the form, of the exemption of state and local government bond interest," and if for "§ 301" we read "the Exception provisions," we have in the foregoing opinion a

complete rejection of the Petitioner's final effort to give some meaning to the Exception provisions while keeping them "inoperative."

It may be that Petitioner means to treat the Exception provisions as being merely "separability provisions" and as having no other effect. The difficulty with this view is that the Code contains an outright separability clause, § 7852 (a), so that there was no occasion for another. Moreover, as Petitioner acknowledges (Pet. Br., p. 76), "the courts presumably would not need statutory authority to adjust the tax" if they found the formula unconstitutional. For this reason also it is not possible to restrict the Exception provisions to the meager role to which the Petitioner consigns them.

Besides, the Treasury Regulation on the subject leaves it not only to the courts but "to the satisfaction of the Commissioner" of Internal Revenue to determine whether to make the adjustments directed by the Exception provisions (Reg. § 1.804-2(f) and § 1.809-3(d)). This contradicts the Petitioner's present theory that only the courts may adjust and then only if they find the basic formula unconstitutional. It suggests that the Petitioner's present theory is an afterthought, *ad litem*, rather than a sound statement of actual Congressional intent in 1959.

To achieve rationality, the Petitioner need only take the final step from the Regulations and recognize that the Exceptions, like all the provisions of the basic formula, are directed in the first instance not to the Commissioner or the courts, but to each individual taxpayer. The Exceptions do not, as Petitioner claims, invite unvarying judicial application of the formula which they authorize to be adjusted. Rather they lay down a rule by which each company can make an adjustment "if it is established in any case" (i.e., the case of a particular tax return for a particular tax year) that the unadjusted formula "results" in a tax on its state and local government bond interest by increasing the company's otherwise tax liability solely as a result of the receipt of the interest.

CONCLUSION

For the reasons stated, the judgment of the Court of Appeals for the Tenth Circuit should be affirmed.

Respectfully submitted,

GRANT SAWYER, Governor of Nevada and Chairman of the *Governors' Conference*

LOUIS L. GOLDSTEIN, Comptroller of Maryland and Chairman of Committee on Taxation of State Bonds of the *National Association of State Auditors, Comptrollers and Treasurers*

JEROME CAVANAGH, Mayor of Detroit and Vice President of the *National League of Cities*

C. BEVERLY BRILEY, County Mayor of the Metropolitan District Government of Nashville — Davidson County, Tennessee and Immediate Past President of the *National Association of Counties*

ROBERT B. MATHIAS, County Counsel of Prince Georges County, Maryland and President of the *National Association of County Civil Attorneys*

C. D. WARD, General Counsel of the *National Association of Counties.*

MITCHELL WENDELL, Counsel to the *Council of State Governments*

JACK P. F. GREMILLION, Attorney General of Louisiana and President of the *National Association of Attorneys General*

JOHN J. O'CONNELL, Attorney General of Washington and Immediate Past President of the *National Association of Attorneys General*

JOHN J. GUNTHER, General Counsel of the *United States Conference of Mayors*

JOHN J. FLEMING, City Attorney of Milwaukee, Wisconsin and President of the *National Institute of Municipal Law Officers*

CHARLES S. RHYNE, General Counsel of the *National Institute of Municipal Law Officers*

DANIEL B. GOLDBERG, General Solicitor of The Port of New York Authority, Counsel for the *Municipal Finance Officers Association* and Secretary of the *Conference on State Defense*

111 Eighth Avenue,
New York, N. Y. 10011.

Amici Curiae

With them on the brief:

CHARLES E. NORMAN,
City Attorney, Tulsa, Oklahoma.

MICHAEL S. ZAKIN,
Attorney, The Port of New York Authority.

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